

Procurement of Default (Basic) Service Power Supply for Residential and Small Commercial and Industrial Customers

Final Comments of the Union of Concerned Scientists, Massachusetts Public Interest Research Group, Clean Water Action, the Conservation Law Foundation, and the Massachusetts Climate Action Network

July 22, 2005

We welcome the opportunity to submit the following final comments to the Department of Telecommunications and Energy (“Department” or “DTE”) in connection with the procurement of default (basic) service power in Massachusetts. These comments are submitted by the Union of Concerned Scientists, Massachusetts Public Interest Research Group, Clean Water Action, the Conservation Law Foundation, and the Massachusetts Climate Action Network, and we incorporate herein by reference our Initial Comments submitted on January 10, 2005, our Reply Comments submitted on January 26,¹ and our oral comments presented at the technical conference on June 20. These comments explicitly address only one of the questions posed by the Department in its May 31, 2005 Notice of Technical Conference: “Should long-term contracts for renewable resources be included as a component of the procurement of power supply for default (basic) service?”

¹ Although the Massachusetts Climate Action Network (MCAN) did not participate in the Initial Comments or Reply Comments, MCAN participated in the June 20 technical conference and joins in these final comments.

Executive Summary:

In this proceeding regarding procurement of default (basic) service power for residential and small commercial and industrial customers, there appear to be few points of significant consensus. But two concepts that are seemingly embraced by most if not all stakeholders are, first, that a substantial fraction of customers in Massachusetts do not currently have viable competitive alternatives and are therefore served under default (basic) service, and second, the electricity costs of those ratepayers without substantial competitive alternatives must be minimized.

Importantly, requiring default (basic) service providers to enter long-term contracts for renewable energy meeting the basic standards of prudence would (1) put an end to the imprudent and costly means by which they are currently meeting their Renewable Portfolio Standard (RPS) requirements; (2) provide an element of price stability for a long period of time² *without* an associated cost premium for this benefit and *without* the likelihood of stranded costs; and (3) foster the ability of the Commonwealth to meet its important commitment to the RPS.

In view of the foregoing, we recommend that the Department issue an order that includes the following:

- All default (basic) service suppliers should be required to solicit offers for long-term contracts (of at least 10 years) for renewable energy sufficient to match, at a minimum, their incremental RPS compliance target for the current year, and to enter into long-term contracts meeting standards of prudence promulgated by the Department;

² In accordance with sound risk management practices and the recommendations of the National Commission on Energy Policy (NCEP), medium and long-term components of default service procurement are expected to reduce price and supply volatility that consumers otherwise face. See National Commission on Energy Policy, Ending the Energy Stalemate: A Bipartisan Strategy to Meet America's Energy Challenges, at 90-96 (Dec. 2004), available at http://64.70.252.93/newfiles/Final_Report/index.pdf (last visited July 21, 2005).

- The requirements to solicit long-term contracts should extend to seeking offers not only for Renewable Energy Certificates (RECs), but also for both the power and the associated RECs;
- In any procurement review process where a default (basic) service provider has not entered into long-term contracts to meet at least its incremental RPS compliance target for the then-current year (and instead is meeting those RPS requirements through short-term REC purchases or paying ACP), it should be required to identify the reasonable efforts it made to enter into long-term contract(s) for an equivalent amount of RECs, and the analytical basis for reaching that conclusion. Further, it should calculate the price below which RECs would have to fall in years following a short-term procurement in order to justify foregoing any long-term contracts;
- RECs procured by load serving entities (LSEs) to meet their RPS requirements for default (basic) service customers should be treated as fungible and saleable, such that they can be resold to the extent that customer migrate away from default (basic) service at a rate exceeding the rate of increase of annual targets;
- Suppliers should be permitted to recover all prudently incurred costs associated with the procurement of long-term contracts for renewable energy and RECs to meet their RPS requirements for default (basic) service customers;

Current Default (Basic) Service Procurement Practices Fail to Ensure that Costs of Compliance with the Renewable Portfolio Standard are Reasonable and Minimized.

Default (Basic) Service Procurement Must Meet RPS Obligations While Minimizing the Cost of Compliance:

In the face of the significant threat of global climate change and at a time when existing electric generating capacity is at great risk of being outstripped by demand, Massachusetts made an important commitment to fostering the development of clean, new renewable energy sources through the RPS. The Department has recognized this commitment and has encouraged compliance with the RPS, including through long-term contracts. In connection with the Department's 2003 Investigation on its own Motion into the Provision of Default Service (D.T.E. 02-40-B), the Department warned default

(basic) service suppliers that they would need to take steps to minimize their RPS compliance costs:

Because of the large number of customers that receive default service ..., the manner in which distribution companies comply with their RPS obligations will have a significant impact on the market for RPS certificates. ***The Department directs each distribution company, in all future default service and standard offer service filings, to fully describe the manner in which it has complied, or intends to comply, with its RPS obligations... [The Department] will review the filings to ensure that the distribution companies take appropriate steps to minimize RPS compliance costs.***

D.T.E. 02-40-B at 45-46 (Apr. 24, 2003) (emphasis added). In that proceeding, the Department did not set a requirement for long-term contracts for RPS compliance, but invited companies to explore such arrangements “if they provide an efficient way... to comply with RPS requirements.” Id. at 46.

At the technical conference on June 20, suppliers such as National Grid, Select Energy and others indicated that they welcomed the sort of price stability that a long-term procurement contract would provide, but argued that such stability would entail an objectionable premium to be paid that would increase the overall price of procurement. While such a premium may be inevitable in the context of procuring fossil fuel-generated power (given the extraordinary volatility in price of these fuel sources over time), this is not the case with virtually any type of renewable energy. Most renewable energy depends on freely available fuel sources, such as wind, sun, or movement of water.

Thus, as the Department has recognized, default (basic) service suppliers must ensure that they are using the most cost-effective RPS compliance strategies. As set forth

below, the suppliers in fact are failing to minimize the cost of meeting their RPS obligations because they generally have not sought to procure long-term contracts for renewable energy. In fact, default (basic) service providers are failing even to solicit offers for longer-term prices necessary to evaluate whether entering longer-term contracts would be more prudent than their short-term procurement practices for meeting their RPS compliance obligation.

Current Default (Basic) Service Renewable Energy Procurement Practices Are Not Prudent Because They Fail to Minimize the Costs of RPS Compliance.

As set forth in our earlier comments and at the technical conference, renewable energy facilities are uniquely situated to provide price and supply stability through long-term contracts without an associated cost premium for these benefits. Because renewable energy facilities do not rely on fossil fuels, their forward pricing of energy is largely tied to the amortization of initial capital investment. Fossil fuel plants, by contrast, must adjust their pricing to account for future long-term fuel price risk in the form of a premium under any long-term agreement. Moreover, development-stage renewable energy facilities have demonstrated their willingness to offer lower prices in exchange for long-term commitments that they need in order to get critical financing.³ Consequently, a renewable energy generator can offer a lower price for a long-term commitment, whereas a fossil fuel generator will demand a higher price.

Nonetheless, to date all default (basic) service suppliers are either procuring renewable energy through short-term agreements resulting from short-term solicitations, or they are making alternative compliance payments (ACP) to the Massachusetts

³ This is precisely because, as noted by several commenters at the June 20 technical conference, the commodity electricity market provides no liquidity and price certainty beyond two to three years.

Technology Collaborative (MTC). To the extent LSEs are relying on the ACP, they are paying the highest possible price for RPS compliance. RECs purchased through short-term agreements are also substantially more costly than they would be under a long-term agreement. As set forth in our earlier comments, default (basic) service customers are paying approximately 4-5.2 cents per kilowatt-hour for RECs that are understood to be obtainable under long-term contracts for as little as half the cost or less.

That suppliers are missing key opportunities to avoid unnecessary costs for default (basic) service customers in connection with meeting their RPS requirements is made apparent by the success achieved by others in reducing such costs through long-term contracts. For example, through its Massachusetts Green Power Partnership (MGPP), the MTC has been able to secure REC prices at approximately \$25 per MWh, less than half the cost of ACP or entering short-term REC purchase agreements. As noted in our initial comments, the Massachusetts Municipal Wholesale Electric Company (MMWEC) will benefit from paying a reported price of 3.65 cents per kWh for electric energy under a 22-year agreement with the proposed Berkshire Wind project, a deep discount to the current and forward price for electricity.

Long-Term Contracts for Renewable Energy Can Be Expected to Yield Lower Costs than Short-Term Contracts, and Lower Costs of RPS Compliance.

There is ample evidence that long-term contracts correspond to lower costs of new renewable energy generation, and, importantly, no evidence has been presented to the contrary in the present proceeding (or for that matter, elsewhere, that we are aware of). In the present proceeding, renewable energy developers such as UPC Wind

Management LLC and Enxco, Inc. notably have stated that they “can and will offer lower prices for longer-term commitments.” Reply Comments of Enxco, Inc. at 2. A recent effort to explore the relationship of contract duration and price for renewable generation in New York concluded that lower prices were available through longer-term commitments when getting new renewable generation financing was at stake. As shown in Exhibit 1, the all-in price of RECs and energy may be roughly 12 to 28% less per MWh for 15 year versus 5-year commitments, and 10% less for 15-year commitments than 10 year commitments. Of greater interest is that when one considers the cost of the renewable premium, or the REC cost only, there is far greater leverage in longer term commitments: when subtracting the value of the commodity energy, the percentage decrease in REC pricing drops far more quickly as a function of contract duration. \

Long-term contracts for renewable energy are expected to lower RPS compliance costs for default (basic) service customers for two reasons. First, unless long-term contracts are available to renewable energy generators, sufficient renewable energy to meet RPS targets will not become available, and a greater proportion of compliance will be via the payment of ACP. With a trivial number of exceptions (most of which are subsidized), commercial-scale renewable energy generators in the United States have required long-term contracts to attract capital. The lack of availability of long-term contracts to renewable generators in New England is a substantial barrier to attracting capital. Financing and securing permits are the two primary requirements to getting new renewable generation built. Furthermore, even if the market were to offer long-term contracts to renewables, for customers buying default (basic) service, so long as the default (basic) service procurement is short-term and the market is characterized by

supply shortage, the benefits of lower cost from long-term contracting will not be made available to default (basic) service customers. Those competitive wholesale market participants taking the risk of entering into long-term contracts would have no incentive to charge less than short-term market prices to default (basic) service LSEs.

As pointed out by the Attorney General and others at the June 20 Technical Session, today, for the majority of Massachusetts load (primarily residential and small commercial customers), there are few viable competitive options. There is also little evidence from other competitive markets suggesting that this situation will change materially. Significant migration to the competitive suppliers by these customers in the next several years is unlikely. As a result, unless default (basic) service providers act to minimize the cost of RPS compliance to such customers without competitive alternatives, they will continue to overpay for RPS compliance.

It therefore makes sense that at least one competitive supplier, Constellation Energy Group, notably has recognized the benefits of long-term contracts for renewables and has voluntarily entered into such agreements.⁴ As DOER Commissioner David O'Connor indicated, the Commonwealth is also looking to enter long-term contracts for renewable energy to meet the state government's electric consumption needs, and one or more requests for proposal for such renewable energy long-term contracts are anticipated in the near future.

However, despite the obvious benefits, voluntary participation in long-term agreements for renewable energy is the exception rather than the rule. In fact, as we articulated at the technical conference on June 20, it is apparent that current default

⁴ As Constellation indicated at the technical conference, it has entered into a 10 year agreement with the New Bedford Landfill Gas project, another agreement with a wind energy facility in Vermont, and is working on entering additional long-term agreements with wind and biomass facilities.

(basic) service renewable energy procurement practices rely on imprudent short-term REC purchase agreements or ACP, and result in suppliers unfairly burdening consumers with costs that are too high.

Indeed, current REC procurement practices expose LSEs to a viable prudence challenge in connection with the provision of default (basic) service. This is the case because, for a utility's costs to be included in its rate base, its expenditures must be prudently incurred. Boston Edison, D.T.E. 98-119, at 62 (1999); Fitchburg Gas & Electric Light Company, D.T.E. 98-51, at 12 (1998); Boston Gas Company, D.P.U. 93-60, at 24 (1993). In considering whether expenditures were prudently incurred, the Department must base its findings on how a reasonable company would have responded to the particular circumstances and whether the company's actions were in fact prudent in light of all circumstances which were known or reasonably should have been known at the time a decision was made. D.T.E. 98-119, at 62; D.T.E. 98-51, at 12; D.P.U. 93-60, at 24; Western Massachusetts Electric Company, D.P.U. 85-270, at 23-24 (1986); D.P.U. 85-270, at 23-24; Boston Edison Company, D.P.U. 906, at 165 (1982); see also G.L. c. 164 § 94G(a). If the company fails to establish that its costs were prudently incurred, the Department must disallow recovery of those costs attributable to the unreasonable or imprudent performance. See, e.g., Massachusetts-American Water Co., D.P.U. 95-118, at 58 (1996); Massachusetts Electric Company, D.P.U. 95-40, at 33 (1995); D.P.U. 93-60, at 29.

Unfortunately, current default (basic) service procurement policy is failing to produce results that entail *reasonable* RPS compliance costs in accordance with these standards. Given that the default (basic) service providers are paying substantially more

to meet their RPS requirements when they are buying RECs under short-term agreements or paying ACP, and considering that they know or should know that they can achieve substantial cost-savings by entering long-term contracts, it can be argued that the additional costs that they have unnecessarily incurred should be considered imprudent. Critically, default (basic) service providers are not even soliciting prices for longer-term renewable energy and REC contracts, and are therefore not in a position to know and demonstrate the prudence of short-term purchases, should they seek to defend such practices as prudent.

Of course, the Department has an opportunity to expeditiously resolve the issue of imprudent costs incurred in connection with RPS compliance by mandating that default (basic) service providers solicit offers for long-term contracts to meet their RPS obligations, evaluate such offers to assess the mix that minimizes ratepayer RPS compliance cost, and enter into long-term contracts meeting standards of prudence delineated by the Department.⁵ Since the greatest benefits can be achieved through long-term *bundled* purchases of RECs and renewable energy (see our Initial Comments at p. 15), suppliers should be required to solicit and evaluate such agreements. Under such bundled purchases, if energy prices drop, thus making the implicit REC cost higher, customers are still better off. For instance, in 2009 when the RPS target is 4%, customer savings on the remaining 96% of LSE load would dwarf any cost increase to 4% of load due to such a REC price increase. If electricity prices rise, however, the implicit REC

⁵ As noted in our Initial Comments, Massachusetts would not be breaking any new ground by requiring long-term contracts of regulated entities to meet RPS obligations. Other state RPS programs having long-term purchase requirements include California, Connecticut, Colorado, Nevada, New York and New Mexico.

price would fall, providing relief to default (basic) service customers when they would most need it.

Long-term Contracts for Renewable Energy Need Not Entail Any Likelihood of Stranded Costs

It is important to understand that a requirement for LSEs to solicit, evaluate, and enter into prudent long-term contracts for renewable energy should not entail any likelihood of stranded costs arising later in time, contrary to suggestions made by several parties at the June 20 technical conference. Those who advanced the stranded costs argument relied primarily on the purported uncertainties tied to load base over time (from day to day, month to month, and year to year) and suggested that LSEs would be saddled with long-term contracts for RECs that may ultimately exceed their minimum RPS obligations over time. But this argument is unfounded because (i) based on experience in any other competitive electricity market, the rate of customer migration away from default (basic) service providers is unlikely to exceed the rate of annual increase in the RPS target, and (ii) RECs can be re-sold to anyone who has RPS compliance obligations.

There is no reason why RECs purchased through long-term contracts in order to meet RPS obligations in connection with the provision of default (basic) service should not be able to be re-sold later in time, especially in connection with any actual migration of customers that reduces an LSE's RPS compliance obligations. Under such circumstances, in the unlikely event that the LSE should be unable to sell its excess RECs

purchased through a long-term agreement at a cost equal to or greater than the cost paid, it should be entitled to recover any shortfall so long as it was prudently incurred.

In arguing that long-term contracts pose an unacceptable risk of stranded costs, some LSEs also postulated a scenario of plummeting REC prices falling below the contracted prices. This argument assumes an unlikely circumstance, namely RECs becoming available in amounts exceeding both RPS requirements and demands from the voluntary market for renewable electricity supply. Even in the unlikely event that this should occur, the magnitude of such costs would necessarily be trivial compared to stranded costs incurred in the past, for two reasons. First, existing stranded costs are in large part due to the construction expenses of nuclear power plants, which make up a substantial portion of total generating capacity and output in the region. In contrast, long-term contracts for renewables would only apply to the RPS requirement, which is a small percentage of total supply. Second, the capital costs of the nuclear plants ended up being three, four, or even ten times larger than the projections made when regulatory commissions approved their construction. This resulted in very high costs per unit of output, which were not directly recoverable once the electricity market was deregulated. By contrast, given that renewable energy supply would be contracted for under fixed prices, even the highly unlikely scenario of a dramatic fall in the price of RECs would result in stranded costs with a fixed ceiling and at an order of magnitude smaller than consumers are now paying on their bills in connection with nuclear facility costs.

Requiring Long-term Contracts for Renewables Would Also Promote Achievement of the Commonwealth's Important RPS Goals.

While there is some debate over the near-term prognosis for sufficient new renewable energy generating capacity coming on-line to meet the RPS minimum requirements without need for ACP, it is apparent that we do not yet have sufficient renewable energy capacity at this time. As the Department has recognized, the manner in which LSEs comply with their RPS obligations has a significant impact on the market for RECs (D.T.E. 02-40-B at 45); requiring LSEs to meet their obligations through long-term contracts not only would reduce the costs of compliance but also would promote development of renewable energy facilities in accordance with the Commonwealth's important objectives pursuant to the RPS.⁶

In our Initial Comments, we noted that the MTC has developed a competitive solicitation process (the MGPP) to secure long-term contracts for RECs from developers of new renewable energy projects. The MTC and others have recognized that a significant obstacle standing in the way of new renewable energy projects is "the lack of creditworthy entities in the region that are willing to enter into long-term agreements for [the projects'] electric energy and RECs."⁷ The MGPP was intended, at least in part, to help remove such obstacles and thereby expand renewable energy generating capacity.

Although the MGPP program is laudable and has been successful – demonstrating the benefits and viability of entering long-term contracts for RECs while providing critical financial assurance for renewable energy developers – the MTC cannot be

⁶ Because LSEs have an existing obligation to meet RPS requirements, this is *not* a case of inappropriately factoring in environmental externalities, as suggested by the written submission of NSTAR at the June 20 proceedings, but rather an effort to achieve a laudable and necessary state commitment to promoting renewable energy via the RPS statute *in a cost-effective manner*. See Massachusetts Electric Co. v. D.P.U., 419 Mass. 239 (1994).

⁷ Cory, K., et al., Long Term Revenue Support to Help Developers Secure Project Financing, Proceedings from Global Windpower 2004 Conference and Exhibition, at 3 (Mar. 28-31, 2004) available at: http://www.mtpc.org/RenewableEnergy/green_power/MGPPpaperAWEA.pdf#search='Global%20Windpower%202004%20Conference%20and%20Exhibition%20Long%20Term%20Revenue%20Support' (last visited July 7, 2005).

expected to meet the very real need for long-term contracts for renewable energy pursuant to the RPS. We therefore urge the Department to reject the erroneous position advanced by some stakeholders at the June 20 technical conference that the MTC's efforts are sufficient to alleviate any need for suppliers to procure long-term contracts.⁸

The MTC cannot meet the need for long-term contracts for several reasons. First, as explained by the MTC's Renewable Energy Trust Policy Director, Fran Cummings, at the technical conference, the MTC's procurement covers a fraction of the RECs needed to meet present RPS requirements. In fact, MTC's ongoing funding is insufficient to support a similarly sized program. The scale of MTC's initial MGPP efforts was based on the accumulation of past collections over a number of years. Though the MGPP program resulted in a number of long-term contracts for RECs in 2004 and is expected to do the same in 2005, it is our understanding that the MTC's ongoing SBC collections are insufficient to continue the MGPP program (or otherwise enter into a significant number of long-term contracts for RECs) after this year for a period of at least five years. The need for suppliers to follow MTC's admirable model thus will grow, not diminish, over the upcoming years. Moreover, the articulated perception that it is MTC's role (or even duty) to enter long-term contracts with renewable energy facilities to help meet the minimum RPS commitments is erroneous. In the near future, MTC reportedly expects to return to other means of fostering renewable energy development in the Commonwealth by, *inter alia*, working with local communities to promote distributed renewable energy generation (e.g., construction of wind turbines to run municipal facilities, etc.).

⁸ In addition to the numerous comments that were advanced on this subject at the June 20 technical conference, the written submission of NSTAR also reflects this position. See "NSTAR Position Outline, DTE-04-114 (sic), Meeting 6/20/05."

Finally, at the same time the MTC's commitment to entering long-term contracts for RECs is being significantly diminished, the actual need for such agreements is only growing. As noted by UPC Wind Management in its January 24 comments in a sentiment echoed by many others, "The inability to secure long-term (12-15 year) financeable power and REC contracts poses the single largest challenge in realizing [wind energy projects actively under development]."

Here, by requiring default (basic) service suppliers to enter long term contracts for renewable energy to meet their RPS obligations pursuant to basic standards of prudence, the Department not only would be ensuring more prudent incurrence of RPS compliance costs but also would provide significant collateral benefits to the important goal of renewable energy development.

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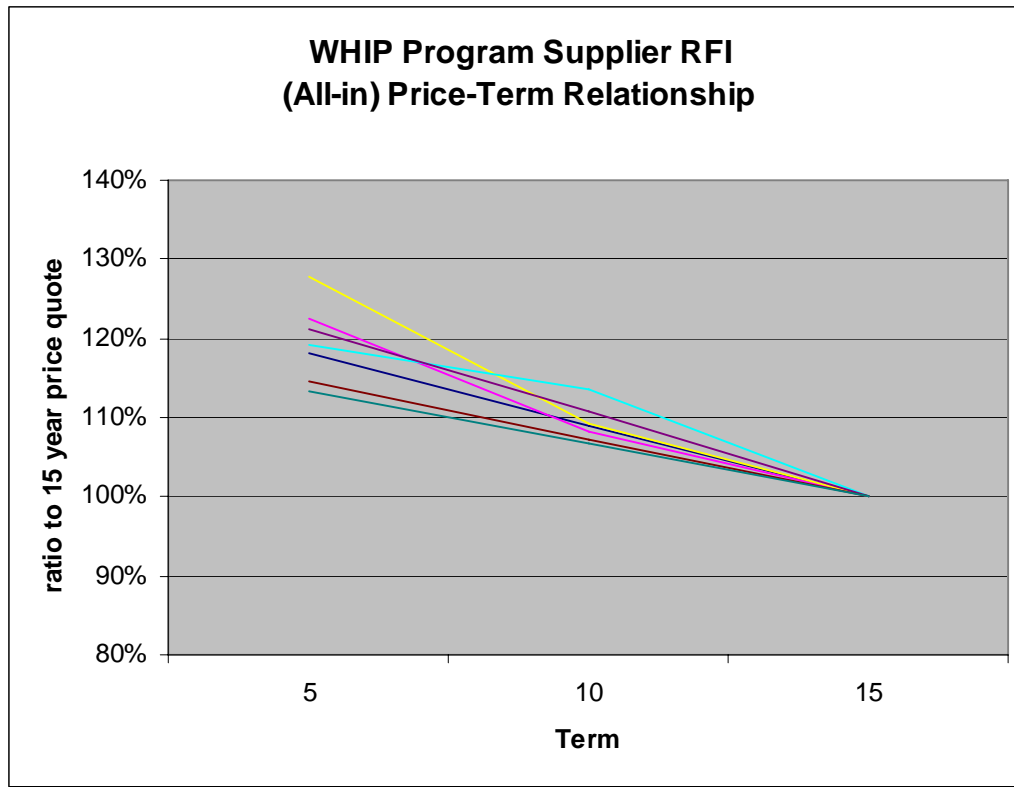
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Exhibit 1:



Source: Based on responses from several New York wind developers to requests for indicative pricing for contracts of various terms representing purchasing both energy and RECs at fixed price, or the financial equivalent, under New York State Energy Research and Development Authority's Wind Hedge Request for Information, 2004. (presented at a June 9, 2005 NYSERDA RPS Technical Workshop by Jonathan Winer (LaCapra Associates))

